94-SBE-017

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 81A-0975-TL
Gene and Donna F. Young	)	
	)	

Appearances:

For Appellant: R. Todd Luoma, Attorney at Law

For Respondent: Patrick Kusiak, Counsel

OPINION

This appeal is made pursuant to section 19045[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Gene and Donna F. Young against a proposed assessment of additional personal income tax in the amount of $41,257 for the year 1975.

[1/] Unless otherwise specified, all section references hereinafter in the text of this opinion are to sections of the Revenue and Taxation Code as in effect for the year in issue.

The issues presented in this appeal are as follows:

(1) Whether a limited partner is required to recognize as cancellation of indebtedness income the failure to restore the deficit balance in his capital account upon the sale of his interest; and (2) if such restoration is required, whether the appellants are entitled to relief under the tax benefit rule.

In 1973, appellant Gene Young (hereinafter appellant) became a 25-percent limited partner in Main Tower Company (Main). Main was engaged in the business of developing a piece of land and constructing an office building thereon in San Francisco. Appellant made a $500 capital contribution to Main in 1974; the project was financed through a $16-million full recourse land purchase/construction loan in 1973. This loan was personally guaranteed by appellant and the general partner. On September 2, 1975, the $16-million loan was replaced by $14.8 million in permanent financing secured by a deed of trust. The $14.8-million note was signed by Main. During 1975, Main's balance sheet showed outstanding $14,700,000 in long-term debt and $105,922 in short-term debt.

According to paragraph six of both the partnership certificate and partnership agreement, appellant is required to make capital contributions in the amount of his interest in the improvements. Appellant is required under the partnership agreement to make further capital contributions of up to 25 percent of any additional working capital required by Main to achieve its purpose or the amount of any final judgment of personal liability against the general partner in favor of any lender providing financing to Main.

From 1973 through 1975, Main incurred over $2 million in expenses for interest, property taxes, and loan fees (collectively referred to as carrying charges), of which appellant's distributive share was $563,243.[2/] However, for California personal income tax purposes, appellants deducted only $84,243, ostensibly because appellants did not have sufficient taxable income in those years.[3/]

On December 18, 1975, appellant sold his interest in Main to the general partner's wife for $1.75 million on an installment basis, with $125,000 being paid in the appeal year. Since appellant's adjusted basis in his Main interest had been reduced to zero, the entire $125,000 was reported as a capital gain. Upon audit, respondent discovered that appellant made no other capital contributions to Main other than his initial $500 investment and, accordingly, treated Main's forgiveness of the resulting deficit in his capital account ($562,743) as a taxable partnership distribution. (See Rev. & Tax. Code, § 17915; I.R.C. § 752(b).) For federal income tax purposes, appellant reported a gain of $687,743, which presumably included the cancellation of either his capital account deficit or his share of Main's

[2/] In a post-hearing submission, appellants indicate this amount should be $518,785, after a federal audit adjustment.

[3/] Respondent alleges appellants were able to deduct all of these expenses on their federal income tax returns, apparently through the use of net operating loss carryovers.

liabilities. The record also reflects a federal tax audit of at least the 1975 year.

A partner's distributive share of partnership losses is limited to his adjusted basis in the partnership interest. (Rev. & Tax. Code, § 17858; I.R.C. § 704(d).) Generally, a partner's adjusted basis in his partnership interest includes his share of any liability incurred by the partnership. (See Rev. & Tax. Code, §§ 17860, 17915; I.R.C. §§ 722, 752; Brountas v. Commissioner, 692 F.2d 152 (1st Cir. 1982).) A limited partner may share in the partnership's recourse debt only to the extent he has an obligation to contribute additional funds in excess of the amount he has actually contributed. (See Treas. Reg. § 1.752-1(e); Temp. Treas. Reg. § 1.752-1T(d)(3); Rev. Rul. 69-223, 1969-1 C.B. 184.) However, if none of the partners have any personal liability (i.e., nonrecourse debt), then all partners, including limited partners, share such liability generally in the same proportion as they share profits. (See Treas. Reg. § 1.752-1(e); Temp. Treas. Reg. § 1.752-1T(e); Rev. Rul. 69-223, 1969-1 C.B. 184.)[4/] When a partner sells his partnership interest, relief of his share of partnership liabilities constitutes an amount realized. (Rev. & Tax. Code, § 17915, subd. (d); I.R.C. § 752(d); Commissioner v. Tufts, 461 U.S. 300 [75 L.Ed.2d 863] (1983); Crane v. Commissioner, 331 U.S. 1 [91 L.Ed. 1301] (1947); Rev. Rul. 74-40, 1974-1 C.B. 159.)

Respondent contends that a partner is required to restore the deficit in his capital account to the extent of his unsatisfied obligation to make additional contributions to the partnership. (See Treas. Reg. §§ 1.704-1(b)(2)(ii)(C), 1.704-1(b)(5), ex. 1(ix) and (x).) Thus, since Main did not require appellant to make such a restoration upon the sale of his partnership interest, respondent determined that the unsatisfied deficit in the capital account constitutes cancellation of indebtedness income. In the alternative, respondent argues the amount realized by appellant upon the sale of his partnership interest includes his proportionate share of Main's liabilities. (See Rev. & Tax. Code, § 17915, subd. (d); I.R.C. § 752(d); Crane v. Commissioner, supra; Commissioner v. Tufts, supra.)

On the other hand, appellant avers that he was not entitled to his distributive share of Main's deductions because the land purchase/construction loan was not obtained by Main, but by two related corporations (Main Spear, Inc., and Main Tower, Inc.), which were nominees of Main. Thus, appellant lacked sufficient basis in his partnership interest, other than the $500 cash contribution, for recognizing such losses, and any deductions taken were done so by "mistake." Further, appellant argues any obligation he had to make additional capital contributions was, at most, contingent, and such contingency was so speculative that an increase in basis therefor would not be permitted. (See Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963).)

We believe respondent prevails on this issue. Even if we accept appellant's contention that his obligation to make additional capital contributions is too contingent, he cannot avoid respondent's Crane/Tufts argument (i.e., income recognition upon discharge of partnership debt(s) when the partnership interest is sold), especially with respect to the $14.8-million permanent financing secured

[4/] These rules allow limited partners to increase their adjusted basis without making any additional capital contributions.

in 1975. Moreover, appellant was permitted to take full advantage of the deductions afforded by Main's financings and it appears that, for federal income tax purposes, appellant was able to deduct in toto his distributive share of Main's losses. This in itself obligates appellant to make additional contributions to Main. (See Rev. & Tax. Code, § 17858: I.R.C. § 704(d).) For appellant to now say that he was not entitled to an increase in basis for his partnership interest is not only audacious, but wholly inconsistent with the actions taken by appellant and the facts as presented in this case. The fact that appellants were not able to deduct the full amount of the Main losses is relevant only to the issue of whether they are allowed to exclude any part of the gain from the sale of the partnership interest, and not to the amount realized and recognized upon the sale thereof.

In this regard, appellant contends that since he received no tax benefit from his distributive share of partnership deductions (other than the $84,243), he should not be taxed on the deficit in his capital account. (See I.R.C. § 111.) Appellant asserts the expenses giving rise to his Main losses are carrying charges and so related to the sale of his partnership interest that they constitute a single integrated transaction. Thus, the tax benefit rule is applicable to allow the appellants to exclude the amount of the unrecognizable deductions from the gain recognized on the sale of the partnership interest. (See Smyth v. Sullivan, 227 F.2d 12 (9th Cir. 1955).) In Smyth, an executor deferred the sale of two pieces of realty until they appreciated sufficiently to cover the liabilities of the estate. Approximately eight years later, the properties were finally sold and the executor was permitted to exclude from the amount of gain recognized the carrying charges incurred during this period because the court determined such expenses were part of a single integrated transaction to sell the property.

This board has had an opportunity to revisit the Smyth decision on at least two occasions. In Appeal of Percival M. and Katharine Scales, decided by this board on May 7, 1963, we found the tax benefit rule not to be applicable to reduce the gain recognized on the sale of realty by the amount of the carrying charges (property tax and interest) which gave the taxpayers no tax benefit. We distinguished Smyth by determining that the taxpayers in Scales acquired their realty for investment purposes, while the executor in Smyth at all times held the property primarily for sale; thus, there was no single integrated transaction in Scales.

Eighteen years later, in an appeal containing facts remarkably similar to those herein, we again rejected the application of the tax benefit rule. (See Appeal of H. V. Management Corp., et al., Cal. St. Bd. of Equal., July 29, 1981.) In H. V. Management, the taxpayer acquired an interest in a partnership which was involved in developing real estate. During the years in which the taxpayer was a partner, it did not have sufficient income against which to deduct its distributive share of partnership losses resulting from carrying charges. When the partnership interest was sold, the taxpayer attempted to reduce the amount of gain recognized by the amount of unused deductions. In denying the use of the tax benefit rule, we found that the carrying charges were not related to holding the partnership interest for sale, but connected with holding the realty for sale. Thus, the single integrated transaction test of Smyth was not met.

Two years after our decision in H. V. Management, the United States Supreme Court enunciated yet another test for the tax benefit rule. The Court held that the "tax benefit rule will 'cancel out' an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. That is, if the event had occurred within the same taxable year, it would have foreclosed the deduction.'[5/] (Hillsboro National Bank v. Commissioner, 460 U.S. 370, 383-384 [75 L.Ed.2d 130] (1983).)

Thus, in Hudspeth v. Commissioner, 914 F.2d 1207, 1211-1213 (9th Cir. 1990), shareholders of a subchapter S corporation were not allowed to reduce the amount of gain recognized upon the redemption of the entity's bonds, even though the shareholders were not able to take full advantage of their distributive share of operating losses in prior years.[6/] In so ruling, the Ninth Circuit determined that income realized from the redemption of bonds is not an event fundamentally inconsistent with previous deductions which are based on the corporation's net losses. The court also reasoned that to grant the exclusion would extend the net operating loss (NOL) carryforward period (which was five years) indefinitely.

In Rosenberg v. Commissioner, 96 T.C. 451 (1991), the United States Tax Court held that the tax benefit rule does not permit a subchapter C corporation's NOL carryforwards to be recharacterized as income exclusions when the entity is later converted to subchapter S status and its assets (realty) are sold.[7/] In so ruling, the court relied upon the fundamentally inconsistent test of Hillsboro and Hudspeth; it also determined that Smyth was not applicable because there were two separate entities - thus, there was no single integrated transaction.

In light of these decisions, we believe the deduction of carrying charges generated by Main and gain from appellant's sale of his Main interest are neither a single integrated transaction nor fundamentally inconsistent events. Smyth is not applicable, for the Main property was not held primarily for sale, but for development, and the carrying charges are relative to ownership of the realty, not to the partnership interest. (See Appeal of H.V. Management Corp., et al., supra; Appeal of Percival M. and Katharine Scales, supra.) Furthermore, we find no fundamental inconsistency between recognizing gain from the sale of a partnership interest and the inability to deduct carrying charges arising from the operation of that partnership, especially when such deductions are unrelated to the sale of the partnership interest. (See Hudspeth v. Commissioner, supra.)[8/]

[5/] While this test is couched in terms of the inclusionary leg of the tax benefit rule, the "fundamentally inconsistent" requirement is equally applicable to the exclusionary portion of the rule.

[6/] Like a partner's basis in his partnership interest, the basis of a shareholder's stocks and/or bonds in a subchapter S corporation is reduced by his distributive share of the entity's losses and deductions. (See generally I.R.C. §§ 705 and 1367.)

[7/] Internal Revenue Code section 1371 strictly prohibits such a conversion and the taxpayer tried to use the tax benefit rule to avoid this provision.

[8/] Examples of some income recognition events which might be fundamentally inconsistent are refunds of property tax due to an improper assessment or return of interest paid because the rate charged by the lender is usurious.

The fact that appellant was not able to fully benefit from his distributive share of Main's deductions was due either to poor tax planning or less than skillful negotiation of the partnership agreement. Appellant was not compelled to partake in this partnership venture - If he was not enamored by the terms of his participation, he should not have agreed thereto. It is well settled that taxpayers are generally free to choose the manner by which to structure their affairs, even when motivated by tax reduction considerations. (See Gregory v. Helvering, 293 U.S. 465 [79 L.Ed. 596] (1935); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 196, affd. on this issue, 752 F.2d 89 (4th Cir. 1985).) Once having done so, however, they are bound by the tax consequences of that choice, whether contemplated or not, and they may not enjoy the benefits of some other path they might have chosen to follow, but did not. (Don E. Williams Co. v. Commissioner, 429 U.S. 569 [51 L.Ed.2d 48] (1977); Commissioner v. National Alfalfa Dehydrating, 417 U.S. 134 [40 L.Ed.2d 717] (1974).) Appellant was able to take full advantage of Main's deductions for federal tax purposes and at least partial advantage for California personal income tax purposes. This was the choice appellant made. To grant relief under the tax benefit rule would in effect give appellant an NOL carryforward for these deductions at a time when, appellant's counsel readily admits, NOL carryforwards were not permitted under California's Personal Income Tax Law.

Accordingly, respondent's action in this matter must be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Gene and Donna F. Young against a proposed assessment of additional personal income tax in the amount of $41,257 for the year 1975 be and the same is hereby sustained.

Done at Culver City, California, this 14th day of December, 1994, by the State Board of Equalization, with Board Members Brad Sherman, Ernest J. Dronenburg, Jr. and Windie Scott present.

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

_______________________, Member

_______________________, Member

*For Gray Davis, per Government Code section 7.9.

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